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What Makes a Bailout Acceptable?

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Abstract: Since March 2008 we have witnessed a flurry of government "bailouts," directed to assist financial institutions. What has made these more or less acceptable to the public is the hope that they are temporary, implemented in a state of emergency, and that they offer market solutions and won't structurally change capitalist relations. However, no temporary stimulus and bailouts can address the systemic instability in financial capitalism identified by Post Keynesians and Institutionalists.

Keywords: financial instability, government bailouts, household debt, Post Keynesian/Institutionalist macroeconomics

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Since March 2008 we have witnessed a flurry of government "bailouts," directed to assist financial institutions. These have been undertaken under a pronounced state of emergency, especially after the deteriorated confidence in financial markets. The paper looks at the initial U.S. government response to the current financial crisis from an Institutionalist perspective. Within an economically conservative environment how did it become more acceptable that the government should act as a lender of last resort and a financial asset purchaser of last resort?

Restoring the Flow of Credit

The financial crisis was approached as a liquidity issue — reflected by the lending facilities created by the Fed, as well as by the three-page initial request for $700 billion by the Treasury given to Congress for what was assumed to be a quick approval, which implied that the repair also was expected to be quick. Financial institutions, however, did face a solvency problem stemming from their ownership of mortgage backed securities. The Federal Reserve and the Treasury have operated under the pretext that

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keeping financial institutions afloat would again secure a flow of credit and would prevent a further slowdown of economic activity.

The belief that consumers and businesses would simply continue increasing their borrowing if provided with credit, together with the fear that the collapse of large institutions would cause havoc in the financial system has provided the justification for the continuous government interventions in support of financial markets. Preserving financial institutions has been the major focus: "We will continue to use all of our resources to preserve the strength of our banking institutions and promote the process of repair and recovery and to manage risks" (Federal Reserve, Treasury and FDIC Statement, November 23, 2008). Among the stated principles that would guide these goals was the commitment to support "a healthy resumption of credit flows to households and businesses." Most of the first $350 billion from the $700 billion stimulus went to banks' capital injection without much being done to prevent the foreclosures from causing the devaluation of these securities. Banks that received assistance were only "encouraged" to facilitate mortgage modifications whenever possible (given the securitization process). The Federal Deposit Insurance Corporation (FDIC) chairwoman has been calling for the Treasury to use $24 billion from the $700 billion rescue package to put into a national scale mortgage modification program. In practice, at this time, however, foreclosure prevention has not been a priority of the rescue actions.

The underpinning presumption has been, and still is, that households and businesses are willing to continue borrowing, which would mean that there easily would be an overall economic recovery (Papadimitriou and Wray 2008, 4). The question is why businesses and households would want to significantly expand their already fragile financial positions by increasing their borrowing amidst decreasing revenue and income flows and amidst declining equity values. In fact, we have observed reduction of private sector deficit spending because of changing perceptions of risk and investment practices, coupled with increased job insecurity (consumer spending, which accounts for 70% of the U.S. economy contracted for the first time in 17 years). As a matter of fact, a large segment of the household sector should not undertake further expansion of debt. For a long time the problem has been the reliance on private sector debt for growth (Papadimitriou, Chilcote, and Zezza 2006; Galbraith 2006; Wray 2006; Todorova 2007).

Since the late 1990s, the private sector took over the deficits previously run by the state and has provided the engine for domestic growth under the conditions of trade deficits. As James Galbraith (2008, 61) points out, this was the "Keynesian devolution," as ". . . the American household took over the job of running deficits from the American government." This was also facilitated by the usage of home equity as the major collateral to support consumption expenditures under the conditions of stagnant incomes; the financialization of benefits – the transformation of the pension system through 401(k) plans; and increasing healthcare expenditures.

Private sector growing indebtedness has been the central reason for the increasing financial fragility. Indeed, the "originate and distribute" banking model required a growing household debt (Kregel 2008, 17-18). Thus, rather than relying on unclogging financial markets so that more borrowing occurs, the response to the crisis necessitates addressing the deeper causes for the growing household sector debt.

Considerations of effective demand and expectations raise the question about the willingness to engage in future production and consumption (Wray 2008; Papadimitriou and Wray 2008). As Papadimitriou and Wray (2008, 5) note, government agencies cannot push on a string to resolve the financial crisis that has transformed into a recession. Proposals about lending at a lower fixed rate made available to households in good credit standing are attempts to push on a string. Such initiatives may slow down the fall in home values but could not alleviate the household debt burden and would not deliver the necessary income growth. In their initial response government agencies, however, seemed to be satisfied with more of the same in terms of focusing almost exclusively on rescuing the financial system viewing it as the main driving force behind expansion of private sector investment and expenditures.

Restoring the Confidence of Portfolio Investors

Restoring confidence in portfolio investors has been a central focus, and the criterion for a successful policy intervention has been the stock market reaction. Downfalls in stock market prices have been used not only as an indicator to determine the need for a bailout of a particular institution, but also have become the objective of government intervention. Thus, signaling to Wall Street a commitment for financial stability has become a major preoccupation of the government agencies.

Investors' assessment of risk based upon transient events such as an announcement of a bailout will not address the systemic nature of the crisis. Preoccupation with Wall Street's reaction to a company's market values is part of the problem. The growing importance of finance has indeed been supported by the continuous policy focus on growth through externally financed investment rather than on growing household incomes, which has contributed to the movement toward financial fragility (Papadimitriou and Wray 2008b, 36). Maintaining stock values has emerged as a major factor in production decisions related to labor cost cutting activities such as outsourcing and downsizing. The process of "financialization" (Crotty 2005; Epstein 2005; Parenteau 2005) has pushed to the extreme the characteristic for capitalist economies subordination of industrial and labor considerations to the pecuniary principles (Veblen [1904] 2005). Hence, it is doubtful that policymakers' focus on Wall Street's reaction is of any positive consequence to the resolution of a financial crisis.

Pecuniary vs. Industrial Considerations

The financial sector has received most of the government support, and considerations of assisting manufacturing, specifically the auto-industry, dragged along discussions about labor contracts and redistribution from labor to capital. Concerns about "Main Street" were most often represented by the requests for loans and credit lines from the three largest American automakers. These requests amounting to $36 billion – a fraction of the sum dedicated to Wall Street were strongly debated. Labor concessions were at the center of these debates. High labor costs were blamed for the unprofitability of the U.S. carmakers, even tough union concessions have already been made, and the reliance of the automakers on now undesirable SUVs and trucks has become too obvious to ignore. Later on in December, President Bush announced $17.4 billion in short-term loans to GM and Chrysler – out of the Troubled Assets Rescue Program that was originally earmarked to rescue the financial industry. The conditions for automakers included labor cost cutting such as putting their retirement plans on a "sustainable footing" and making their compensation competitive with foreign automakers operating in the United States (White House, 2008). Thus, under threat of bankruptcy, the "bailout" to Main Street was initiated only after discussions about restructuring plans that would de facto involve redistribution from labor to capital.

States are also in need of a "bailout." Not only have they been hit by the financial crisis, they face budget shortfalls expected to reach $72 billion in 2009. The federal government is the only one that can "bailout" states and localities to avert these shortfalls. States are expected to cut or significantly reduce medical, rehabilitative, and home care services; K-12 and early education; access to childcare and early education; public colleges and universities; and state workforces (McNichol and Lav 2008). All of these services directly provide serviceability for livelihood.

Until now, however, remoteness from production and serviceability has been associated with larger rescue efforts through economic policy. This is in line with Veblen's ([1899] 1994) discussion of the higher regard for "pecuniary employments" that invoke respect and fear in comparison to "industrial employments" – such as manufacturing and care work. With increased securitization, credit default swap (CDS) markets, and greater inter-linkages, there has been uneasiness about the *unknown* consequences of asset value losses (Das 2006). These "unknowns" have made the bailouts of the financial sector more acceptable to the public by creating larger anxiety about the future.

The macroeconomic policy response has supported consolidation and concentration through mergers in the financial sector, and has resulted in even bigger financial institutions. History shows, this is not the way to reduce financial instability. As Minsky pointed out in 1986, ". . . the giant banks' belief that the Treasury, the Federal Reserve, and other government agencies will provide them with a bail-out in order to prevent a big crash" is destabilizing (Minsky [1986] 2008, 221). The economy is affected by decreased margins of safety in lending and investing. "The authorities, frightened of the unknown consequences of the failure of giant banks, intervene to protect them when they are at hazard, which implies that giant banks are too big for a noninterventionist, free-market economy" (222).

Furthermore, the idea that the government is actually investing and perhaps realizing returns in the future on behalf of the taxpayer has contributed to the better acceptance of the bailouts in the financial sector. The idea of "sound government finance" has been central in terms of emphasis on government returns from participating in the bailouts. While government expenditures directed at the household sector or states are often seen as (undeserved) handouts, and bailout of Main Street is attached to "restructuring" plans involving labor concessions, an expectation for future return from a deal is, to use Veblen's language, "blameless." What Veblen ([1899] 1994)] called "gambling proclivity" or the "belief in luck" can be detected in the taxpayer's hope of the government turning a "profit" from the bailout "deals." This belief in luck makes the financial bailouts more acceptable to the public, while government investment in people through direct job creation for example, and in "industrial employments" remains relatively more unacceptable. Consequently, even within a crisis, at least up until now, what Veblen described as predatory habits and aptitudes ([1899] 1994) are preserved.

Conclusion

What has made the recent bailouts more or less acceptable to the public is the hope that they are temporary, implemented in a state of emergency, and that they offer market solutions and won't structurally change capitalist relations. However, no temporary stimulus and bailouts could address the systemic instability in financial capitalism identified by Post Keynesians and Institutionalists.

Minsky ([1986] 2008) emphasized the role of the government as a lender of last resort, which he connected to the role of government as an employer of last resort. He explained how the destabilizing forces in investment within financial capitalism are generated endogenously, and pointed to the profit motivation behind financial institutions' "innovations" in lending instruments. Minsky (315) realized that financial instability is a deep-seated characteristic of a capitalist economy that called for an adequate institutional framework of financial capitalism.

The inherent tendency to instability in financial capitalism makes the built-in policy that contracts these endogenous forces necessary. Government deficits act as a stabilizer (and yes, while validating the same destabilizing profit motivated "financial innovations"). However, a built-in employer of last resort (ELR) policy addresses both the level, as well as the composition (distributional) aspects of government deficits in times of downturn. It ensures that the composition of these deficits includes a floor for the price of labor, as well as that financial instability won't be detrimental to aggregate demand and output (Minsky [1986] 2008; Wray 1998; Kaboub 2007). For private balance sheets to be repaired at this time, only an ELR type public service employment program could be effective.

In December, President-elect Obama announced his intention to create jobs through public works on infrastructure projects, and to secure aid to states and tax cuts for working families. Retrofitting buildings to make them more energy efficient and mass transit were mentioned as examples of a long-awaited "green recovery" undertaking. Green job creation through public service employment has been advocated by those proposing ELR (Forstater 2004; 2006). The permanency of such public works, however, is crucial – which would suggest abolition of what James Galbraith (2008) called the "impossible dream of budget balance," and acceptance of the principles of functional finance.

In a capitalist economy, household sector debt caps make more sense than the hawkish government deficit caps fancied by some. Preventing household sector saving to fall into the negative could be achieved by addressing health expenditures through universal healthcare and by establishing a floor for wages and benefits through permanent public works. Such an employer of last resort policy will make periodic redistributive and destabilizing "bailouts" obsolete.

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